THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

June 19, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

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Subject: The Outlook for Inflation

Since early February, there has been a 150-200 basis point increase in interest rates. A variety of developments and expectations have disturbed the financial markets and contributed to this rise in rates.

Private credit demand has been very strong, primarily reflecting the strength of the economy; this is adding upward pressure to interest rates. The uncertainties surrounding the LDC debt problem and implications for the condition of the U.S. banking system have also added to the markets' negative psychology. There is a growing uncertainty and pessimism about future inflation; this has been an important factor, particularly in the upward movement in long-term rates. Skepticism about future inflation interacts with the concerns about large projected budget deficits because the markets fear that large deficits will lead to an inflationary monetary policy.

Although there is as yet no convincing evidence of rising actual inflation, forecasts of higher future inflation have become more prevalent and inflationary expectations are very important to the behavior of long-term interest rates. Because there is a strong expectations element in the behavior of long-term rates, it is critically important that the Administration avoid any appearance or implication of advocating or endorsing an inflationary monetary policy.

To the extent that there are market forces adding upward pressure to interest rates, there is little that the Federal Reserve can do to offset those forces. If the Federal Reserve were to accelerate reserve and money growth in an attempt to suppress interest rates, it might succeed in temporarily holding down short-term interest rates. Many would argue that even that temporary result would not occur; at best, it would be very short-lived. If there were some limited and momentary success in suppressing short rates, the more rapid money growth that resulted would be inflationary. Thus a Federal Reserve policy designed to hold rates down will ultimately have the reverse effect as the resultant inflation and inflationary expectations would likely cause a steep and rapid rise in long-term rates. The Administration should therefore send clear public signs that such a monetary policy is neither recommended nor condoned.

Inflation and Money Growth

Historically there has been a close and predictable association between the long-run, trend rate of money growth and inflation; an acceleration (deceleration) in the trend rate of money growth has corresponded to a similar acceleration (deceleration) in inflation with a lag of 1-1/2 to 2 years. Currently the 2-year rate of money growth is about 9%. This rate of monetary expansion is the most rapid on record and exceeds those that preceded the sharp acceleration of inflation of the mid- and late 1970's. This is the basis of the more pessimistic forecasts for inflation currently being suggested. Milton Friedman, for example, has predicted that inflation will rise to 8-9% by the end of 1984. This is consistent with other inflation estimates that are based on the historical money-price relationship.

The financial deregulations instituted in late 1982 and early 1983 caused some uncertainty about the meaning of the very rapid M1 growth that occurred from mid-1982 to mid-1983. That uncertainty leads some to doubt the forecasts of inflation based on money growth rates that encompass that period of time.

If one believes that financial deregulation has caused either a one-time shift, or a permanent change, in the historical, behavioral relation between money growth and aggregate spending (velocity), it is reasonable to infer that the rapid money growth of 1982-83 will not have the inflationary impact that one would expect, based on historical experience; it is then logical to conclude that the outlook for inflation is less ominous. However, if one believes that the historical velocity relationship remains basically intact, despite financial innovation, then one must conclude that money growth over the past two years will result in a significant rise in inflation by the end of this year. Conversely, in order not to foresee a reacceleration of inflation in the very near future, one must believe that the basic money-price relation has been altered.

Variables that have historically been good leading indicators of inflation -- such as gold and other commodity prices -- have as yet shown no convincing signals of rising future inflation. Some have argued that this should allay our concerns about inflation. The problem with this analysis is that these leading indicators of inflation have in the past given misleading signals -- failing to foreshadow rising inflation or signalling a change in inflation that never materialized. Thus, such predictors of inflation are not infallible.

It is this pervasive uncertainty about the inflation outlook that haunts the financial markets. Financial market participants' experiences during the 1970's have made them acutely aware of the capital losses associated with underestimating the path of future inflation. In addition to the inflation expectations built into the level of interest rates, there is, therefore, a risk premium in interest rates that is associated with the fear that actual inflation will turn out to be higher than expected.

Inflation and Federal Reserve Policy

In recent public statements, Federal Reserve officials have emphasized the threat of future inflation and the need to constrain money growth to limit that threat. Such statements are, at least in part, designed to convey to the financial markets the Federal Reserve's commitment to a noninflationary policy in order to contain the adverse effects of rising inflationary expectations. The following is a good example:

> "Too often in the past, we have lacked the courage or the patience to stay long enough on a monetary and fiscal path that will lead to noninflationary economic growth. We cannot afford to backslide once again. Unless we achieve a less inflationary environment, there will be little chance of sustaining the expansion...."[1]

Although this excerpt would fit well into statements currently being made by Federal Reserve officials, it was actually made in 1977. The fact that such statements were made, but not lived up to, is illustrative of the financial markets rational fears about future inflation. Another 1977 Federal Reserve report to Congress stated,

> "The long-run growth rate of physical production... is probably around 3-1/2% at present. Judging by the experience of the past two or three decades, a stable price level would require a rate of expansion of M1 that over the long run is well below the growth rate of total output."[2]

Despite these statements of good intentions, M1 growth accelerated from 6.1% in 1976 to over 8% in 1977 and 9% in 1978, while inflation rose from 4.8% in 1976 to 9% in 1978 and 13.3% in 1979.

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[1] From "Statements to Congress," Federal Reserve Bulletin, May 1977, pg. 468.

[2] Ibid., February 1977, pg. 124.

Thus official pronoucements about Federal Reserve intentions to pursue a noninflationary policy provide the financial markets with no assurance that that policy will actually be adhered to. Financial market participants have heard such statements before, but subsequent policies were not consistent with them; despite policy statements to the contrary, policy actions allowed money growth and inflation to accelerate. Most important, those investors who believed official statements about a commitment to inflation control experienced financial losses.

The Outlook

There is likely to be some slowing in real economic activity, but this should be viewed as natural and desirable; there is considerable momentum in economic activity and no reason, at present, to doubt that a reasonable rate of economic expansion will continue. It is also possible that a slowing in real economic activity could quell the markets' concerns about rising inflation and thereby contribute to some decline in interest rates.

The chances of a monetary restriction of the economy, which many feared five or six months ago, have diminished. In the last six months, money growth has averaged about 6% and, for the most part, M1 has remained within the upper half of the Fed's 4-8% target range. This is adequate to support continued economy expansion.

Between now and the election, the major risk associated with the economy is rising interest rates. Attempts by the Federal Reserve to prevent rate increases are likely, at best, to fail and, at worst, to exacerbate the situation. Attempts by the Administration to "bash" the Fed or to coerce the Fed into trying to hold rates down would be the worst possible course of action. Signs that the Fed is reverting to inflationary monetary policy -- or that the Administration is advocating that policy -- would only reinforce, and ultimately validate, the markets' worst fears about rising future inflation. While no one likes the idea of rising rates, the best defense against that occurrence is for the Federal Reserve to follow a policy of moderate and noninflationary monetary policy, with the full and public support of the Administration.